Chapter Seven

Shifting from Public to Private Production

As the preceding analysis of the Department of Defense's depot-level maintenance indicates, allocating work based on the different strengths of public, private, and mixed production could significantly increase the share of maintenance that is done in the private sector. Yet even if that analysis is valid, it will be irrelevant unless it can accommodate political realities as well as military risk and costs. The nation may not find it acceptable to depend more on the private sector for maintenance unless the process of transition is perceived as fair both to the 95,000 employees of government depots and to private-sector firms. The discussion that follows outlines different ways in which DoD might make that transition if it decided to increase the share of maintenance done in the private sector.

Reassign Workloads and Close Public Depots

DoD could increase the private sector's share of maintenance by starting to contract out more work. That policy would raise the level of excess capacity within the public depots, and DoD could then rely on the Base Realignment and Closure Commission (BRAC) or a similar process to close those depots that it would no longer need. Private industry might support that approach, particularly if the closed DoD depots were not made available for reuse as private maintenance facilities. But many people would see it as unfair to public employees. Those employees, it might be argued, had never had an opportunity to show that their facilities could compete successfully for DoD's business in an open market.

Another drawback to this approach is that stopping repair work in a depot could prove an unnecessary and costly disruption for DoD in situations in which continued operations, albeit under private ownership and management, would be the most cost-effective solution. Based on DoD's past experience in closing bases, shifting workloads to the private sector and shutting down depots would involve significant up-front costs. Analyses conducted by the staff of the Commission on Roles and Missions of the Armed Forces assume that the up-front costs associated with closing a typical depot are on the order of $500 million. (Those costs would vary widely, however, depending on the particular depot.) That figure is generally consistent with the findings of the model that DoD uses to estimate the costs of base closures. In addition to up-front costs, DoD might initially have to pay more for its maintenance as private-sector firms learned to handle the new workloads.

Immediately Privatize the Public Depots

A second approach would be to convert an operating depot to private ownership through a public stock

offering or a negotiated sale. The agreement could include a fixed-price contract for specific maintenance tasks, with a minimum guaranteed workload that would decline over time according to a preestablished schedule. The continued operation of the facility for the duration of the contract could be a condition of the sale. If environmental problems restricted DoD's ability to sell a depot outright, the prospective new owner could purchase a lease from DoD that included an option to buy once environmental remediation was under way.

Employees of DoD depots might find privatization a more attractive alternative than depot closure because they would have an opportunity to seek employment in the private facility. In contrast to closing a depot, immediately privatizing it would also provide the military with an experienced source of maintenance while buying time for other private firms to develop the capability to compete for those workloads. (However, private firms that already owned repair facilities and would have to compete against the newly privatized facilities might prefer that DoD close rather than privatize its depots.)

Although DoD's up-front costs under this approach might be less than under a base closure, they could still be substantial. Among those expenses would be the cost of separation payments to employees, the cost of transferring to the remaining public facilities any work that DoD did not want to go to the private sector, and the cost of purchasing rights to proprietary data. (Such purchases would be necessary if DoD owned the right to use data in its own depots but not the right to provide the data to private firms.)

This approach could also create costs for the federal government by unnecessarily prolonging the operation of some inefficient facilities. Even after they were sold, facilities that did not produce efficiently would continue to operate for the duration of the initial maintenance contracts. The federal government would ultimately bear the cost of those operations, since prospective purchasers would take those costs into account in calculating what they should bid for the facility and for the accompanying initial maintenance contracts. In some cases, the government might receive little if any up-front revenue from the sale of a depot and would be forced to pay high prices for the maintenance performed under the initial contract.

Prepare Depots for Privatization

A third approach, similar to the one that the Congress mandated for the uranium enrichment program in the United States, first converts the public operation into a government corporation and then sells the corporation to the private sector.[1] In that model, the government corporation is an interim step while the facility converts to commercial management and accounting practices and demonstrates its viability and market value (or lack thereof) to potential purchasers. According to experts on privatization in other countries, government enterprises can be more easily and more profitably converted to private ownership if the enterprise is already in a corporate form.[2] Without that step, the government might find that private firms were unwilling to purchase DoD depots even if the accompanying initial maintenance contracts were quite generous. In the case of the United States Enrichment Corporation, the Congress considered that interim step necessary even though the facilities were already operating as government-owned/contractor-operated plants.

Adopting commercial accounting and management practices might call for several major changes for the former DoD depots. For example, to make a depot comparable with a private firm, the Congress might require it to lease its facilities from DoD at an estimated market rate and make payments in lieu of taxes to the Treasury. The Congress might also require the depot to raise capital for future investment

1. Energy Policy Act of 1992, Title IX, "United States Enrichment Corporation," as codified in Title II of the Atomic Energy Act of 1954; 42 U.S.C. 2297.

2. Statement of Tony Dale, Budget Manager, New Zealand Treasury, before the House Committee on the Budget, March 1, 1995.

in private financial markets without government guarantees. In addition to those requirements, it might leave the depot's management and labor free, as they are in the private sector, to negotiate wages and the terms of employment.[3]

To ensure their viability during the transition, the former public depots might initially be granted a DoD contract with some level of guaranteed workload (at a fixed price). That level might decline over time according to a preestablished schedule. After a brief transition period (perhaps three years), the government would transfer ownership of each depot to the private sector through a public stock offering or a negotiated sale. At that point, the continued operation of the enterprise would depend on its ability to earn a market rate of return.

Because this transition approach would allow depots to establish a track record in competitive markets, it could provide a smoother transition to private ownership (and a better chance for the facilities' long-run survival) than would the depots' immediate sale. But the strategy has a substantial risk: the second step might never be taken. Unique facilities that would not be subject to competition (such as those for inactivating nuclear ships) might appropriately remain government-owned corporations. But in situations in which competition is possible, privately owned enterprises appear to be more efficient than publicly owned ones.[4] No matter what the charter of the corporation might say, the government's ownership of it increases the potential for appropriating money to cover losses and for introducing political goals. The risk that the government would continue to own and operate the facility might be greatest in the case of those depots that were unable to earn an adequate rate of return.

3. Some adjustments could be necessary to ensure fairness. For example, in the case of the United States Enrichment Corporation, established in 1993, federal employees who agree to transfer to the corporation can choose to remain under the federal retirement system.

4. See Anthony E. Boardman and Aidan R. Vining, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises," *Journal of Law and Economics*, vol. 32 (April 1989), pp. 1-33.

Why Consider a Transition?

The transition to greater use of private maintenance would involve risks and costs for DoD even if an effort was made to keep existing depots in operation as private facilities. The one-time costs for personnel associated with privatizing a typical depot employing 3,500 people would be about $70 million. (Personnel costs would be even greater if DoD transferred some of the workload from that depot to another public facility and had to bear the costs of transferring and training new employees.) Depot closures and, to a lesser degree, privatizations would also pose short-term risks because they could disrupt ongoing maintenance programs. In addition, the transition from a public to a private or mixed mode of production--however it was achieved--could entail long-term risks in that DoD would be dependent on contractual relationships with its suppliers rather than having direct authority.

DoD's core policy, as the services currently apply it, would allow DoD to avoid the costs and risks associated with shifting maintenance to the private sector. The core approach emphasizes the necessity of using public depots to maintain the frontline systems that the Joint Chiefs of Staff's scenario requires. Under that policy, the percentage of work done in public depots would increase in the Air Force and Army. Compared with an approach that would raise the share of maintenance allocated to the private sector, the DoD core approach lessens the need to close additional public depots. (Even so, additional public depots may have to be closed. After taking into account the base closures and realignments that the BRAC process identified in 1991 and 1993, the aviation depots in the public sector will still have significant levels of excess capacity.)

In the short run, changes in public and private roles are likely to entail costs and risks. Over the long run, however, greater reliance on the private sector where appropriate could offer the government the potential for significant savings--perhaps on the order of $1 billion annually. And the benefits could

go beyond the realm of costs. Competition in the private sector might encourage innovation and push suppliers to improve the quality of the maintenance they provided to DoD. Moreover, private industry has manufacturing and repair capabilities beyond those available in DoD's depots. The services already depend on the private sector to repair some specialized components of frontline weapon systems. The quality of the maintenance support that U.S. forces receive in wartime might actually improve if DoD's focus shifted from asking how it could maintain capabilities in its own depots to how it could gain rapid, reliable access to the capabilities of private industry, and particularly those of the private defense industry.

Finally, some of the people who support privatization throughout the government argue that industrial activities should, as a matter of principle, be left in the private sector to the maximum extent possible. That same principle underlies DoD's core philosophy, with its emphasis on maintaining only the minimum essential capabilities in the public sector. The difference in outcomes stems from different views of what the private sector can accomplish.